ALERTS

Sixth Circuit Upholds Assignment of Rents to Secured Lender

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"[T]he debtor … did not retain sufficient rights in the assigned rents under Michigan law for those rents to be included in the bankruptcy estate," held the U.S. Court of Appeals for the Sixth Circuit on May 2, 2017. *In re Town Center Flats LLC*, 201 U.S. App. LEXIS 7733, *2 (6th Cir. May 2, 2017). Relying on Michigan law and the language of the relevant documents, the court reversed the bankruptcy court's holding that gave the Chapter 11 debtor access to the assigned rents as operating funds during its reorganization.

Relevance

The Sixth Circuit acknowledged the debtor's asserted "policy concern that excluding the assigned rents from the estate would effectively foreclose Chapter 11 relief for companies like [the debtor here] that own single property and receive their sole stream of revenue from rents of that property." *Id.* at *16. Courts continue to debate the issue.

Bankruptcy Code ("Code") § 363(a) defines "cash collateral" to include not only "cash," but also "rents, … *subject to a security interest* as provided in § 552(b) … whether existing before or after the commencement of a [bankruptcy] case … ." (emphasis added). Although Code § 552(a) generally provides that property acquired by the debtor after the commencement of a bankruptcy case is *not* subject to a lender's pre-bankruptcy security interest or mortgage, § 552(b)(2) allows a lender's pre-bankruptcy lien on rents to extend to post-bankruptcy rents. When the lender's security interest or mortgage (i.e., lien) extends to post-bankruptcy rents, Code § 363(c)(2) bars the debtor or the trustee from

using that "cash collateral" unless the lender "consents" or the court, after appropriate notice and hearing, "authorizes such use … ." The court may condition that use, though, on the debtor's providing the lender with "adequate protection … against diminution in value of its collateral … ."). *In re SCOPAC*, 624 F.3d 274, 278 n.1 (5th Cir. 2010), relying on Code § 363(e).

Lenders often hold an absolute assignment of rents, however, not a mere lien. In so-called "title theory" states, the lender may have title to and exclusive ownership of post-bankruptcy rents depending on the terms of the assignment and the applicable state law. The Third Circuit, for example, has held that a debtor's absolute assignment of rents transferred all rights and interests in the rents to the lender under New Jersey law. *In re Jason Realty, L.P.* 59 F. 3d 423, 427 (3d Cir. 1995) (finding that Chapter 11 debtor had no interest in any post-bankruptcy rents under New Jersey law and could not use them to fund its reorganization, even under the limitations imposed for the use of cash collateral; the U.S. Supreme Court has mandated "that we interpret the assignment as New Jersey courts would construe it outside the bankruptcy context"). *First Fidelity Bank, N.A. v. Eleven Hundred Metroplex Assocs.*, 190 B.R. 510, 513 (S.D.N.Y. 1995) (Sotomayor, D.J.) ("assignments granted to the lenders absolute title to the rents under New Jersey law, not merely a security interest"; assignment was "virtually a carbon copy" of the assignment considered in *Jason Realty*); *Sovereign Bank v. Schwab*, 414 F.3d 450 (3d Cir. 2005) (applying Pennsylvania law, bank that enforced its rights under mortgage gained legal title to rents; rents were thus not part of debtor's estate). Thus, when a court construes the assignment of rents to be absolute, neither the debtor nor a trustee will be able to use the rents, for the rents belong exclusively to the lender. *See generally*, *K.R. Heidt, "The Effect of the 1994 Amendments on Commercial Secured Creditors,"* 69 Am. Bankr. L.J. 395, 404 (1995).

In a "lien theory" state, however, a lender will not be entitled to possession of rents even if it holds legal title to the property. *In re Millette*, 186 F.3d 638, 644 n.10 (5th Cir. 1999) (In "title theory" states, mortgagee holds title to land from outset alone until debt satisfied; in "lien theory" states, the borrower holds title to land and mortgagee has lien; in "intermediate theory" states, the borrower maintains title to the property, but once the loan is in default, the mortgagee immediately receives title and right to possess the property); *Commerce Bank v. Mountain View Village, Inc.*, 5 F.3d 34, 38 (3d Cir. 1993) ("The title theory [in Pennsylvania] permits the creditor to enter the land upon default, but in lien states, the creditor is

required to foreclose or have a receiver appointed"). *See In re Buttermilk Towne Center, LLC*, 442 B.R. 558, 567 (BAP 6th Cir. 2010) (rents are part of debtor's estate under Kentucky law; rent assignment language "isolated" in context of entire agreement; rents served only as "additional security"; assignment ended when underlying debt satisfied). *In re Guardian Realty Group*, 205 B.R. 1, 4 (D.D C. 1997) (in dicta, court disagreed with *Jason Realty*, and noted that in determining whether mortgages "constitute a mere security interest, or instead, ownership," under Delaware law, courts "must look to the substance of state law rights, not merely the label that state law places on them."); *In re Princeton Square Associates*, 201 B.R. 90, 95-96 (Bankr. S.D.N.Y. 1996) (in single-asset Chapter 11 real estate cases, debtor in possession should be permitted to use rents to maintain property even though rents had been assigned to lender prior to bankruptcy, constituting an absolute transfer of title under New Jersey law). Recent cases decided under New York law are split. *Compare In re Loco Realty Corp.*, 2009 WL 2883050 (Bankr. S.D.N.Y. June 25, 2009) (held, when debtor signed assignment of rent under New York law, debtor prevented from spending rent) and *In re Soho 25 Retail, LLC*, 2011 WL 1333084 (Bankr S.D.N.Y. Mar. 31, 2011) (held, rent not property of estate under New York law because debtor at most had revocable license to rent; thus unavailable to debtor); *with In re South Side House, Inc.*, 474 B.R. 391 (Bankr. E.D.N.Y. 2012) (held, assignment of rent under New York law was in nature of pledge for additional security only; debtor retained sufficient pre-bankruptcy interest sufficient to bring rent within estate).

Facts

The debtor owned a residential complex in Michigan subject to a $5.3-million mortgage "and an agreement to assign rents to the [mortgagee] in the event of default." *Id.* at *2. Specifically, the debtor "irrevocably, absolutely, and unconditionally [agreed to] transfer, sell, assign, pledge and convey to [lender], its successors and assigns, all of the right title and interest of [the debtor] in … income of every nature of and from the [property], including, without limitation, minimum rents [and] additional rents … ." *Id.* at *2-*3. The assignment purported to be a "present, absolute and executed grant of the powers herein granted to [lender]," while "granting a license to [the debtor] to collect and retain rents until an event of default, at which point the license would 'automatically terminate without notice to [the debtor].'" *Id.* at *3. Of course, the rents were the debtor's "only source of income." *Id.*

When the debtor later defaulted, the lender sued in the Michigan State Court, seeking, among other things, foreclosure and the "appointment of a receiver to take possession of" the debtor's property. *Id.* at *4. The debtor then filed a Chapter 11 petition, causing the lender to move for an order preventing the debtor "from using rents collected after the [Chapter 11] petition was filed." In response, the debtor argued that it "would have no income to work with in its Chapter 11 reorganization plan if the rents were not part of the bankruptcy estate." The bankruptcy court agreed, denied the lender's motion, finding that the rents constituted cash collateral. *Id.* at *5. After the district court vacated the bankruptcy court's decision, the Sixth Circuit agreed to dispose of the debtor's appeal on the merits.

Analysis

Federal courts, explained the Court of Appeals, must rely on state law to determine property rights and the extent to which a property interest is included within the debtor's estate. *Id.* at *4-*5.

Assignment of Rents in Michigan

A relevant Michigan statute provides in pertinent part that an "assignment of rent shall be binding upon [the debtor] only in the event of default in the terms and conditions of [the] mortgage … ." *Id.* at *5. The Michigan statute also provides that the assignment of rents, "when so made, shall be a good and valid assignment of the rents to accrue under any lease or leases in existence or coming into existence during the period the mortgage is in effect … ." *Id.* at *6.

The Michigan Supreme Court, when construing this statute in another case, held that the lender stands "in the shoes of the mortgagor until the debt is paid, with all his rights to the rents and profits, as long as he, under the general law of mortgages could enjoy them." *Id.* at *9, quoting *Smith v. Mutual Benefit Life Ins. Co.*, 362 Mich. 114, 520 (1960). Moreover, the Michigan Court of Appeals held that a "prior perfected interest in assigned rents had priority over an interest held by a judgment creditor who sought to garnish rents." *Id.* at *9, citing *Otis Elevator Co. v. Mid-America Realty Investors*, 206 Mich. App. 710 (Mich. Ct. App. 1994).

"Michigan courts have generally treated the assignment of rents as a transfer of ownership once the agreement has been completed and recorded and a default has occurred." *Id.* at *9-*10. Relying on its analysis of Michigan law, therefore, the court found "that the Michigan Supreme

Court would treat a completed assignment of rents as a transfer of ownership." *Id.* at *10.

No Security Interest

The circuit court also rejected the debtor's argument that the Michigan statute only gave the lender a security interest in the assigned rents. *Id.* at *11. The language of the underlying agreements broadly confirmed the irrevocable, absolute and unconditional transfer of the rents to the lender. The debtor clearly had "assigned the rents to the maximum extent permitted by Michigan law." Therefore, reasoned the court, the debtor had transferred ownership "in the assigned rents to [the lender] before the bankruptcy petition was filed." *Id.* at *12.

No Residual Interest

The court further rejected the debtor's argument that it had retained a residual interest in the rents. Any restriction on the lender's use of the rents did not give the debtor any vested rights, for the Michigan appellate courts have held that a debtor has no interest in the rents after the assignment, depriving the debtor-assignor of any residual property rights. *Id.* at *14.

Finally, the court's holding "is in line with the majority of bankruptcy court decisions that have addressed this issue." *Id.* at *15. Despite the negative impact of its holding on single-asset real estate debtors, the Sixth Circuit stressed that "Michigan law … is clear on the matter and governs despite other policy concerns." *Id.* at *16.

Authored by Michael L. Cook.

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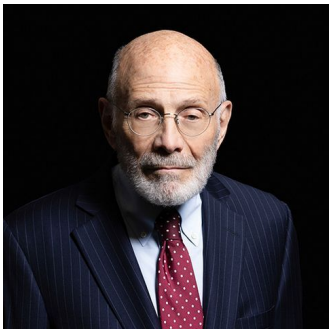

Michael Cook

Of Counsel

New York

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